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Taxation - Federal Estate - Flight Accident Insurance - Proceeds Included in Gross Estate of Deceased - Commissioner v. Noel

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CASE NOTES

TAXATION — Federal Estate — Flight Accident Insurance — Proceeds Included in Gross Estate of Deceased. Commissioner v. Noel, 380 U.S. 678 (1965).

Before enplaning, decedent acquired two flight insurance policies[1] for his round trip flight to Venezuela, which, aggregating 125,000 dollars in coverage, insured against loss of life or bodily injury resulting from an aircraft accident occurring during any part of the flight. The wife, who was the death beneficiary,[2] paid the premiums and retained possession of the policies after the deceased instructed the sales clerk to "give them to my wife. They are hers . . . ." Three hours later the plane crashed into the Atlantic Ocean, leaving no survivors. The respondents, executors of the decedent's estate, filed the required estate tax return after decedent's death, but did not include the amount paid under the insurance policies in the assets of the gross estate on the ground that, "the policies in question are not 'policies on the life of the decedent' within the meaning of the statute."[3] The tax court upheld the Commissioner's assessment of a deficiency.[4] On appeal, the Court of Appeals for the Third Circuit reversed,[5] holding that the insurance policy was an accidental flight policy and section 2042(2) does not include this type

1. One policy was issued by the Fidelity and Casualty Co. of New York, the other by Continental Casualty Co. Each policy contained the following clause: "CHANGE OF BENFICIARY: The right to change of beneficiary is reserved to the insured and the consent of the beneficiary or beneficiaries shall not be requisite to surrender or assignment of this policy or to any change of beneficiary or beneficiaries, or to any other changes in this policy."
2. The proceeds were payable to the insured if bodily injury alone was sustained.
3. Estate of Marshall L. Noel, 39 T.C. 466, 470 (1962). The statute referred to is INT. REV. CODE OF 1954, § 2042 providing in part:
The value of the gross estate shall include the value of all property—
(1) RECEIVABLE BY THE EXECUTOR.—To the extent of the amount receivable by the executor as insurance under policies on the life of the decedent.
(2) RECEIVABLE BY OTHER BENEFICIARIES.—To the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person. For purposes of the preceding sentence, the term 'incident of ownership' includes a reversionary interest (whether arising by the express terms of the policy or other instrment or by operation of law) only if the value of such reversionary interest exceeded 5 per cent of the value of the policy immediately before the death of the decedent.
4. Estate of Marshall L. Noel, 39 T.C. 466 (1962).
5. *In re* Noel's Estate, 332 F.2d 950 (3d Cir. 1964).

of insurance. Certiorari was granted,[6] and the United States Supreme Court reversed and *held*: (1) that the administrative interpretation of the statute has received congressional approval, and that "flight accident insurance" is in effect insurance taken out on the life of the decedent within the meaning of section 2042(2); and (2) that there was no valid transfer to relieve the decedent of the incidents of ownership.[7]

The Estate Tax Provisions of the Revenue Act of 1916 did not specifically include the proceeds of life insurance policies which were paid to beneficiaries other than the decedent.[8] Consequently, in 1918 Congress included a provision, the forerunner of section 2042, for the inclusion of amounts "receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life . . . ."[9] This provision was re-enacted several times without change until it was rewritten by Congress in the Revenue Act of 1942. The latter provided that insurance proceeds payable to designated beneficiaries were includible in the decedent's gross estate if he (1) paid the premiums directly or indirectly, or (2) possessed at the time of his death any of the incidents of ownership exercisable either alone or in conjunction with any person.[10] These are more commonly referred to as the "premiums paid" test and the "incidents of ownership" test. Since the "premiums paid" test was deleted in the 1954 Code,[11] the "incidents of ownership" is the sole test of taxability under present law when the proceeds are not payable to the estate.[12]

The primary issue faced by the Supreme Court in the principal case[13] was whether or not section 2042(2) includes proceeds from flight accident insurance. The Internal Revenue Code was of little help in resolving the latter question, for there are no definable guide lines for the term "insurance."[14] The Treasury Regulations explain the term as "life

6. Commissioner v. Noel, 379 U.S. 927 (1964).
7. Commissioner v. Noel, 380 U.S. 678 (1965).
8. Int. Rev. Act of 1916, ch. 463, § 202(a), 39 Stat. 777.
9. Int. Rev. Act of 1918, ch. 18, § 402(f), 40 Stat. 1098.
10. Int. Rev. Act of 1942, ch. 619, § 404(a), 56 Stat. 944.
11. INT. REV. CODE OF 1954, § 2042(2).
12. P-H 1965 FED. ESTATE & GIFT TAX Par. 120422.2.
13. Commissioner v. Noel, *Supra* note 7.
14. Int. Rev. Code of 1954,§1035 defines life insurance, but the definition applies to that section only.

insurance of every description.'"[15]

Ackerman v. Commissioner[16] is the only prior case that involved the status of proceeds derived from accident insurance.[17] In *Ackerman* the petitioner's argument was that policies taken out by the decedent upon his own life referred to life insurance in the ordinary meaning of that term, and could not include accident insurance.[18] The Tax Court rejected this reasoning, stating that:

> It is well recognized that there is a distinction between life insurance and accident insurance, the former insuring against death in any event and the latter (where accidental death policies are involved) against death under certain contingencies, but we fail to see why one is not taken out upon the life of the policyholder as much as the other. In each case the risk assumed by the insurer is the loss of the insured's life, and the payment of the insurance money is contingent upon the loss of life.[19]

Although the above language from *Ackerman* has never been controverted by Congress or the judiciary, the Court of Appeals[20] in the instant case departed from a decision that has been in effect for thirty-five years.

The appeals court decided that the critical issue was the construction of the term "insurance,"[21] which in turn necessitated a construction between life insurance and accident insurance. Life insurance was found to be payable:

> upon the occurrence of an inevitable event. The

15. Treas. Reg. § 20.2042-1(a) (1958) which continues, "including death benefits paid by fraternal beneficial societies operating under the lodge system."
16. Ackerman v. Commissioner, 15 B.T.A. 635 (1929).
17. *Id.* at 635. The case was also concerned with double indemnity provisions of an ordinary life policy insuring against loss resulting from death by accidental means.
18. Petitioner's argument was based on Int. Rev. Act of 1924, § 302(g) which provides in part:
The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated . . . (g) . . . and to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life.
19. Ackerman v. Commissioner, *supra* note 16, at 637.
20. *In re* Noel's Estate, *supra* note 5.
21. INT. REV. CODE OF 1954, § 2042. It is to be noted that the term "life insurance" does not appear in § 2042. Instead the term "policies on the life of the decedent" is used, thus the argument that the term is susceptible to a broader interpretation.

> contingency insured against is the death of the insured regardless of its cause unless, of course, the cause is one excepted under the policy . . . . Life insurance has several economic and investment features not common to accident insurance. Upon issuance of the policy the insurer assumes an absolute risk of loss and the insured acquires an immediate estate which by the terms of the policy is transferable on his death.[22]

Accident policies, on the other hand, were found to be payable:

> for any loss sustained by reason of an event which is evitable and not likely to occur. The contingency insured against is the accident, death being only one of several liability creating consequences . . . . Upon issuance of the policy the insurer assumes a conditional risk of loss and the insured, as well as the beneficiary, acquires nothing more than an inchoate and defeasible right.[23]

The Supreme Court found this distinction between an "inevitable" and an "evitable" event to be totally unacceptable. It then reaffirmed *Ackerman*[24] as the law, stating:

> [T]he language [of 2042(2)] makes no distinction between 'policies on the life of the decedent' which are payable in all events and those that are payable only if death comes in a certain way or within a certain time.[25]

The Supreme Court also based this part of its decision upon the Treasury Regulations remaining unchanged from the time of the *Ackerman* decision[26] and the fact that Congress has never attempted to limit the scope of that decision, or the established administrative construction of section 2042(2), although it has re-enacted that section and amended it in other respects a number of times.[27]

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22. *In re* Noel's Estate, *supra* note 5, at 952.
23. *In re* Noel's Estate, *supra* note 5, at 952-53. Also see Johnston, *Flight Insurance and Federal Taxation: a Critical Examination of the Noel Case*, 1965 DUKE L.J. 32, for a critical analysis of this argument.
24. Ackerman v. Commissioner, *supra* note 16.
25. Commissioner v. Noel, *supra* note 7, at 681.
26. *Id.* at 681. 26 C.F.R. § 20.242-1(a) (1) provides: Section 2042 provides for the inclusion in a decedent's gross estate of the proceeds of insurance on the decedent's life (i) receivable by or for the benefit of the estate . . ., and (ii) receivable by other beneficiaries . . . . The term 'insurance' refers to life insurance of every description, including death benefits paid by fraternal beneficial societies operating under the lodge system.
27. See statutes cited *supra* notes 8, 9, 10 and 11.

After disposing of the insurance question the court was still faced with the issue of whether or not decedent had divested himself of all "incidents of ownership."

The phrase "incidents of ownership" has never been completely defined by the courts. Generally, any economic interest in, or control over, the policies or their proceeds is an "incident of ownership." The statute makes no attempt to define this nebulous term; however, the regulations provide:

> [T]he term 'incidents of ownership' is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term has reference to the right of the insured . . . to the economic benefits of the policy. Thus, it includes the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc.[28]

The fact that an insured may exercise incidents of ownership over the policies in conjunction with others only, will not relieve the insurance proceeds from the tax. The statute specifically provides that the possession of such rights may be either by the decedent "alone or in conjunction with any other person."[29] Incident of ownership is the sole test of taxability under present law, and to escape inclusion within section 2042(2) the policy holder must totally divest himself of all these incidents.[30]

The decedent's executors contended that the policies would not come under the provisions of section 2042(2) for the deceased had in fact divested himself of the incidents of ownership. They based this contention upon the following grounds: (1) the wife of decedent had purchased the policies; (2) decedent had given the policies to his wife, thereby depriving himself of power to assign the policies or to change the beneficiary; and (3) the contractual power to assign or change beneficiaries was illusory.

28. Treas. Reg. § 20.2042-1(c)(2).
29. INT. REV. CODE OF 1954, § 2042(2).
30. P-H 1965 FED. ESTATE & GIFT TAX ¶ 120422.2.

The Supreme Court rejected the executors' first ground, finding that even if the decedent's wife had purchased the policies, "what she bought nonetheless were policy contracts containing agreements between her husband and the companies."[31] The Tax Court did not even consider this provision, stating that "taxability under the 1954 Code does not depend upon who paid the premiums . . . ."[32] The second ground was dismissed on the holding that there was not a valid assignment, for the contract terms provided that the policies could not be assigned nor could the beneficiary be changed without a written endorsement on the policies. In the instant case the assignment was oral, and thus the terms of the policy were not fulfilled.

Although decedent had no practical opportunity to divest himself of the incidents of ownership, the court still rejected the argument that "this power was illusory,"[33] stating that "these circumstances disabled him [decedent] for the moment from exercising those 'incidents of ownership' over the policies which were undoubtedly his."[34] This result may appear to be harsh, but it is in accord with the above Estate Tax Regulation.[35] This result is also in accord with Internal Revenue Service rulings that an airline passenger has retained the "incidents of ownership" even though he delivered the policies to his wife, and as a practical matter it was impossible for him while the plane was in flight to exercise those incidents of ownership retained by him under the policy.[36] However, the Tax Court in the principal case noted that the policy was for the round trip flight, and that the decedent could change it prior to the return trip.[37]

The Supreme Court did not consider whether or not the policy was for round trip or one-way flight. It now appears that it makes no difference whether round trip or one-way

31. Commissioner v. Noel, *supra* note 7, at 683.
32. Estate of Marshall L. Noel, *supra* note 4, at 471.
33. By "illusory" the respondents meant that there was no opportunity for decedent to exercise the rights of assignment and thus divest himself of the incidents of ownership. The Tax Court in its opinion admitted that there was no procedure available at the airport for the insured to change any of the terms of the policy.
34. Commissioner v. Noel, *supra* note 7, at 683.
35. Treas. Reg. § 20.2042-1(c)(2).
36. Rev. Rul. 61-123, 1961-2 CUM. BULL. 151.
37. Estate of Marshall L. Noel, *supra* note 4, at 472-73.

flight insurance is purchased; if one cannot effectively transfer the policy with all its incidents of ownership, the proceeds will be included in the estate under section 2042.

Thus, the problem of how to accomplish divestment remains, for it is the existence of the right, rather than its exercise that is determinative of includibility.[38] Even complete divestment might not prevent tax liability, for once the insured has divested himself of all incidents of control, the Commissioner may still try to levy a tax on the philosophy of section 2035 of the Internal Revenue Code of 1954, which provides that transfers made within three years of the decedent's death create a rebuttable presumption of being made in contemplation of death, and thus are includible in the decedent's gross estate.

A possible solution for this dilemma that has been proposed[39] is to have the airport policies written (assuming that they can be) so that the insured need not be the applicant and so that the rights in the policy need not originate with him. Then the insured could have the beneficiary accompany him to the airport, apply and pay for the flight insurance, and be the owner of the policy (possessing all of its incidents of ownership) from the outset.

However, for the commuter who flys a great deal, the procedure of having the beneficiary accompany the insured to the airport could prove to be inconvenient. In such a situation it would be more feasible for the wife to purchase an annual accidental death policy on her husband's life.[40]

In conclusion, this decision has reaffirmed the *Ackerman* case,[41] which was law for thirty-five years. In so doing it has undoubtedly cleared the muddy waters created by the Third Circuit Court of Appeals. It also sets forth the proposition that the incidents of ownership in the decedent is the first criteria to be examined in determining the includibility of such proceeds in the decedent's estate, and not the type of insurance proceeds received.

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38. Singer v. Shaughnessy, 198 F.2d 178 (2d Cir. 1952).
39. IBP TAX PLANNING IDEAS p. 4 (May 12, 1965).
40. *Id.* at 4-5.
41. Ackerman v. Commissioner, *supra* note 16.